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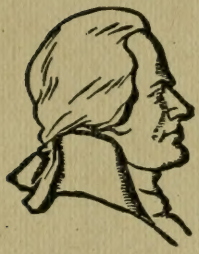
[Modern business talks]

TALES TOLD BY FIGURES

Inadequate accounting methods often lull the business man into a false sense of security.

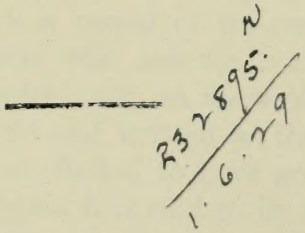


MODERN BUSINESS
TALK No. 18

ALEXANDER HAMILTON INSTITUTE
NEW YORK

Tales Told by Figures

Number Eighteen of a Series of Modern
Business Talks Prepared by the
Alexander Hamilton Institute



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NEW YORK

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READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk, (2) Pages 186 to 390 of Volume 9, "Accounting Principles," and (3) Problem 9.

Things are often of value in direct proportion to the difficulty in obtaining them. Some reading requires more concentration than others. It brings its reward not only in the increased power that concentration gives, but in the knowledge gained. An understanding of accounting principles is fundamental for sound business judgment.

Tales Told by Figures

"It is not enough for the owner to know the amount of profit or loss; he must know the sources of profit and the causes of expense."—Page 204, Chapter XII, Volume 9 of the MODERN BUSINESS TEXT.

A mercantile house of considerable size had a retail stock ledger that proved to be an embezzler. For many years it had been regarded as a book of exemplary habits, and nobody suspected it of leading a double life. But this is usually the way with embezzlers. They are often pillars of society; they fool even their best friends.

The way this stock ledger came to grief makes an interesting story with a moral of its own. It so happened that the man who ran the business also ran short of ready cash—not an unusual thing in business. Much is said and written on the subject. Often the trouble is attributed to poor goods or to bad salesmanship. Again it is said to be the result of advertising that does not advertise. Frequently these charges are true enough.

When a business loses money and fails, you do not usually find that Bradstreet and Dun report the trouble as being the fault of the books. But in this particular case the merchant began to suspect that

something was wrong with his books and he promptly set a watch. He put a detective to work shadowing that staid old retail stock ledger for the purpose of discovering what it did with his funds. This detective was armed with a warrant from the office of a certified public acountant.

Suspicion Verified

At the very outset, the Profit and Loss account was observed to act strangely. Somehow it showed that the merchant had made a gross profit of $1,162.49 during a certain month, when the merchant himself knew well enough that he hadn't. At least, if he had, he couldn't locate it in the cash or anywhere else.

After watching the suspected account for some time, the detective one day reported to his employer that he had caught it red-handed. When searched, it was found that a balance of $493.71 in this account was wholly fictitious. It had arisen in consequence of a final mark-down and various small leakages and other losses. But there the figures were on the books—bold, unmistakable, unblushing. The money was not in the cash drawer; nor was there an equivalent in increased assets or diminished liabilities. It wasn't in the store anywhere, nor had the merchant spent it.

Where was it, then?

Why, in the pockets of perhaps ten thousand customers who had bought at the store during the week.

It was made up of driblets that had gone out over the counters as unrecorded losses. It could never be recovered.

A Costly Omission

To explain in detail just how it had been possible for the item of $493.71 to exist fictitiously in the Profit and Loss account is a rather long story, but the gist of the matter is easy enough to understand and quite sufficient for our purpose. The merchant's sales were so numerous and so complicated that it was impossible to keep a perpetual inventory system showing quantities and values item by item. Consequently he used the retail stock ledger, and like many another merchant, not realizing the pitfalls of such a system, he did not think it necessary to go to the expense of checking this ledger occasionally by means of a physical inventory of costs.

Unless such physical inventory at cost is taken periodically, the profits shown by the retail stock ledger are mere estimates. In the course of a few years the accumulated difference between the estimated and the actual figures may, in a concern of any considerable size, easily amount to a very large sum.

The first three chapters of our assignment (Chapters XI to XIII) discuss at length the statements prepared from the books for the purpose of showing present conditions both as to assets and income. The various classes of assets and liabilities, the functional classification of operating costs and the prep-

aration of a balance sheet are matters that demand careful consideration if the accounting system is to represent accurately the present condition and the future outlook of the business. Not only that, but the credit manager, the banker and others who have to determine a concern's financial worth from the statements submitted by it, must be able to analyze such statements and to judge of their apparent truthfulness.

An Expedient That Failed

Some time ago an eastern manufacturer who was in financial straits thought to tide over his affairs by borrowing at the bank beyond what his financial condition actually warranted. He adopted the simple device of marking up his plant, machinery and inventory accounts, thereby showing a largely inflated surplus. To the bank president who was not familiar with the exact nature of the manufacturer's business, the financial statement seemed satisfactory. However, when the statement was referred to one of the directors who was in a similar line of business and who also was an accountant, the inflated values were at once discovered and the loan refused. Very probably the bank was thereby saved from a heavy loss.

There are many interesting kinds of discrepancies between the actual facts and the tales which bookkeeping statements sometimes would have us believe, but to the trained accountant these discrepancies offer no illusions. Such illusions are based

upon the popular belief that "figures can be made to say anything." But the trained accountant doesn't base his judgment solely upon some one else's figures. He analyzes and verifies and uses a little common sense before forming a definite conclusion. That's what makes him an accountant and not just a bookkeeper.

When Ignorance Spelled Insolvency

The Chapter on "Opening and Closing Entries" (Chapter XIV) is especially valuable as showing how the books of a new business should be opened. In bookkeeping as in other matters, it is important to begin right. Many concerns which have made elaborate preparations for manufacturing and marketing, have ignored the importance of starting their records aright. Frequently the proprietor or manager is satisfied with delegating to some routine bookkeeper the task of keeping all records relating to the business, as tho that were a matter of only slight importance.

Thus in the case of a retail business, the affairs of which were being aired in court, the proprietor testified that he himself knew nothing of bookkeeping, and that he left all of that work to his office force. On cross examination he was asked if he considered accounting a part of his business procedure. "Yes," he replied, "but not a part of my individual procedure."

"Do you regard buying as a part of your individual work?" he was asked.

"Yes, of course."

"And sales?"

"Yes."

"And profits and losses?

"Certainly."

"And still you are not personally concerned with the methods of recording and measuring the buying, the selling and the profits and losses?"

"Well," he hesitated, "I never studied bookkeeping."

This was a case in which the correctness of the books was questioned by creditors. It was subsequently shown at the trial that the accounts were grossly inflated and that the business was insolvent, tho no evil motive was charged. It was simply a case of ignorance of accounts.

Keeping Books On a Spindle

Even more primitive was the method used by the owner of a small mercantile business who, for a whole year after he established it, neglected to open any general books. He always intended to "brush up" on bookkeeping, but never found time for it. Meanwhile he used a spindle on which he stuck slips of paper with memoranda more or less disjointed whenever he remembered to do so.

But it happened that the creditors brought a law suit against him and it then became necessary to show various transactions and their influence on the business. It was then that this merchant's peculiar bookkeeping system was brought to light. The

court ruled that scraps of paper stuck on a spindle were not legal evidences of accounts, even could they be rendered intelligible—which in this case they were not.

In Chapter XV the author describes various labor-saving devices tending to insure accuracy and promote speed in the making of entries, especially in the matter of posting to the ledger. He devotes Chapter XVI to a presentation of means adapted for checking the correctness of the various recorded activities of the business which involve the purchase or distribution of supplies, the use of cash, etc. These are excellent practical suggestions that tend to simplify the accountant's work and thereby prevent errors from creeping into his records.

What Is the Correct Depreciation Rate?

The subject of depreciation is one that frequently presents difficulty to the accountant and that sometimes is responsible for misleading statements of assets and values. According to the author, a great deal of misconception exists as to the correct theory of depreciation; consequently errors make their appearance in the accounts. Failure to charge depreciation gives to assets a fictitious value that may cause serious trouble. Chapters XVIII and XIX are replete with sound information on this subject, and show by practical examples how the proper amount of depreciation is determined.

A prominent specialty manufacturing concern found itself "up against" a problem of this sort a

few years ago. The sales department was using a number of touring cars in order to enable its salesmen to reach conveniently the many factories that were scattered thru the city suburbs. The delivery department, too, was using motor trucks for delivery purposes. The problem of depreciation was further complicated by the fact that the company maintained branch offices in many cities in which conditions of traffic varied greatly. After a few years it was found that the cars had to be replaced more frequently than had been expected, and that their given depreciation rate did not agree with actual conditions.

But how could this rate be accurately determined?

The company, being a pioneer in the field, had to gather the necessary data from every available source, including automobile manufacturers, large and small users under similar conditions, and dealers in both new and second-hand machines. This required considerable effort, but the result justified it. The company now has an automobile "mortality table" that puts the depreciation account on a scientific basis.

Unless some accounting mechanism is provided whereby the depreciation may be accurately traced, the results of the business and the possibilities of its future cannot be shown. A great many business concerns, however, are dodging this issue, either thru ignorance of accounting or because the executives in charge prefer to skim the cream today and let their successors go hungry.

But even tho the accounting system in itself may approach perfection, it is of little value if operated by an incompetent bookkeeper. Many a firm has employed a low-salaried bookkeeping force imagining that thereby it is keeping down expenses, when in reality it is accumulating losses. Some time ago the head of a very large hardware house declared in a magazine article that one of the chief causes of failure was an accounting system that did not account.

"More business goes wrong by poor accounting," he said, "than by poor salesmanship or bad buying."

A prominent expert accountant in New York is credited with the statement that the accounting in two-thirds of the business houses of the United States comes very far from telling the truth.

Sometimes important departments of a business are conducted for years at a loss when proper accounting would have shown the trend of things at the very beginning. Improper posting of sales, wrong distributions of expense, faulty handling of freight items—these and many other accounting factors enter into the causes of insolvency much oftener than is generally supposed. When looked at from the standpoint of the broad-minded, successful manager, an investment in scientific accounting is one of the necessary expenditures of a going business.

The last chapter in the book gives us an exhibit of a series of transactions to which accounting principles are applied and the various records and entries

made. Here may be traced in its proper order each operation, so that nothing is left unexplained. The chapter is a fitting close to a decidedly interesting presentation of the subject of accounting principles, and renders easy the complete mastery of the subject by the ordinary business man.

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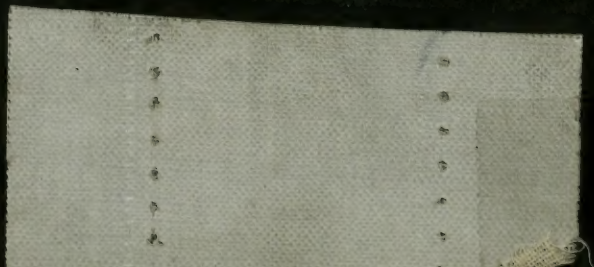

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